

WHAT'S NEW AT GOULD & RATNER

In the past few months, Gould & Ratner has represented clients in several significant matters:

- the sale by two separate clients in the cellular telephone business (one for a price in the high nine figures and the other for \$130 million),
- a \$15 million investment in a web design client;
- several environmental cleanup matters, several zoning matters;
- several purchases and developments of hotels and office buildings;
- a \$100 plus million refinancing of a downtown office building;
- significant trademark litigation involving a famous brand name;
- several significant estate plans including family partnerships, gifts and other devices;
- a number of foreclosure actions on behalf of a finance company;
- counseling regarding options for key executives; and
- representing several internet early stage companies in receiving investments and several investors in making investments in companies ranging from satellite transmission, competitive telephone, e-commerce, and web design.

[INCOME TAXATION OF NON-QUALIFIED STOCK OPTIONS *continued from page 3*]

Because the options in the example are not traded on an exchange nor otherwise have a "readily ascertainable" value, the grant of the options is not a taxable event. Once the employee exercises the options, the tax consequences are governed by Internal Revenue Code §83.

Since the employee's ownership of the stock is conditioned upon continued employment and the stock is not freely transferable, the employee does not recognize compensation income until one of these restrictions lapses.

This arrangement may prove costly from a tax perspective to the employee: when the restrictions lapse on July 1, 2009, the employee recognizes compensation income equal to fair market value on date of lapse (\$50) less the exercise price (\$10). The employee thus recognizes \$40 of compensation income taxed at ordinary income tax rates. In short, where the restrictions lapse after a number of years – at a time when the stock value has risen dramatically – the employee will be forced to recognize a large amount of compensation income taxable at ordinary income tax rates.

A potential solution to this dilemma is to make an election under Section 83(b) of the Internal Revenue Code to accelerate the compensation income (the "§83(b) Election"). The §83(b) Election permits the employee to "close out" the compensation element as of the date the options

are exercised and effectively allows the employee to limit ordinary income from the transaction to the difference between the fair market value of the stock on the option exercise date and the amount paid for the stock and options. Any appreciation in the stock after this date constitutes capital gain, as and when the acquired stock is sold, which is taxed at favorable rates.

In the above example, the employee could file the §83(b) Election on July 1, 2004 (i.e. upon exercise), and would recognize compensation income in that year equal to the fair market value at date of exercise (\$15) less the exercise price (\$10). By filing the §83(b) Election, the employee reduces her compensation income from \$40 to \$5.

Careful planning is required for any executive compensation package which includes non-qualified stock options. Through proper structuring of the option agreement, restrictions on the stock, and timely tax elections, the various goals of employer and employee can be resolved at minimal tax cost.

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ESTATE PLANNING – IS IT TIME FOR A CHECK-UP?

When clients come to Gould & Ratner to have their estate plans prepared, we continually reinforce that estate planning is very much like your health, and periodic check-ups are not only needed, but required. So, if you have an estate plan that was previously prepared and signed and which is safely locked up in your safety deposit box, perhaps you should retrieve it, look it over and ask yourself the following questions:

1] When Was The Last Time You Had An Estate Planning Check-up?
In other words, when was the last time you and your lawyer met to review your estate plan. Most probably, your estate plan was drafted with a great deal of flexibility to anticipate changes in your life, but no plan can anticipate every change and as a result, your plan may be outdated. In developing an estate plan,

your net asset value dictates many of the planning opportunities, some of which are generally drafted to minimize death taxes. As a general rule, estate planning needs change as your financial assets and those of your spouse's move from \$675,000 to \$1,350,000 and beyond that level. These changes to your net asset value require consideration of new estate planning strategies – such as testamentary trusts, irrevocable lifetime trusts, irrevocable life insurance trusts, private annuities, grantor retained annuity trusts, intra-family sales, qualified personal residence trusts, family limited partnerships, limited liability companies and charitable remainder trusts. The booming economy has increased the value of your retirement accounts, stock and bond portfolio, insurance policies, interests in businesses, your residence and other assets. This also increases the need for more sophisticated estate planning.

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A Newsletter from the Law Firm

GOULD & RATNER

G&R Review is published by the law firm of Gould & Ratner to update clients and friends on legal trends and developments of interest. The material contained in this newsletter is only a synopsis of recent cases and legislative developments and is not legal advice. If you have a question or an individual claim involving a topic covered in this newsletter, you should seek a legal opinion based on the law as a whole and the facts of your particular case.

Comments, questions, and requests for additional copies of this newsletter can be directed to Laura W. Thompson at Gould & Ratner, 222 North LaSalle Street, Suite 800, Chicago, Illinois 60601. (312) 236-3003 or lthompson@gould-ratner.com.

THE TAX MAN COMETH

Property owners in Cook County will start receiving in spring their Notice of Proposed Assessment from Assessor James M. Houlihan. Be forewarned that the assessment is "proposed" in the same sense that a trial judge "proposes" a verdict and sentence: You have a right of appeal.

For tax year 2000, townships in the City of Chicago will be reassessed as part of the County's triennial reassessment schedule. Assessed values on commercial and industrial properties are conservatively estimated to be proposed at levels 15 to 20 percent above 1997 levels.

Even properties that are not subject to reassessment for year 2000 might still be entitled to tax relief. Watch for these telltale signs:

- Taxes greater than 7.5% of fair market value
- High vacancy rate
- Substantial destruction or damage to premises (e.g., fire, flood)
- Declining or stagnant market values
- Obsolete function and design.
- Higher assessed valuation than comparable properties.

For a confidential discussion of your property, call Theodore M. Swain or Frederick R. Dempsey upon receipt of your notice of Property Assessment.

[ESTATE PLANNING – IS IT TIME FOR A CHECK-UP? *continued from page 1*]

Many clients who did not have an estate tax exposure five or ten years ago, find that today they have a significant potential death tax burden. Do not make Uncle Sam your newly adopted child who could benefit significantly from your estate – call us today to get an estate planning check-up.

2] When Was The Last Time You Filed A Gift-Tax Return? Many clients are well aware and take advantage of the \$10,000 annual gift exclusion. In many cases, a special type of trust called a "Crummey Trust" is used to hold annual exclusion gifts for beneficiaries. If your spouse joins with you in making the gift, the annual gift exclusions to each beneficiary increases from \$10,000 to \$20,000. Technically, to take advantage of this gift-splitting election, you must file a gift tax return.

Perhaps you have established trusts so that your children's inheritances will remain in trust for their lifetime. The reasons for creating these trusts are many, but two of the most important reasons are to keep the inheritance out of the marital estate should your child marry, and to avoid having your children incur an estate tax. To ensure that your gift planning will be effective, gift tax returns should be filed and Generation Skipping Transfer Tax ("GST") exemptions should be specifically allocated and applied to the gifts, where appropriate. We can quickly review your gifts and your trusts to ensure that your goals are being accomplished.

3] Who Is The Owner And Beneficiary Of That Old Life Insurance Policy On Your Life That You Have Stuck In The Drawer? Life insurance is an asset that, if handled correctly, can be excluded from your estate and your spouse's estate, thereby maintaining the full amount of proceeds, unreduced by inheritance taxes at your death, your spouse's death and, potentially, your children's death. Using an ILIT, you can avoid the insurance proceeds being subject to estate tax rates as high as 55%. It would be terrible to have Uncle Sam be the beneficiary of upwards of 55% of your life insurance proceeds. An easy way to determine who the owner and beneficiary of your policies is to look at your policy or your premium statement. If you are unable to ascertain the ownership and beneficiary, we will be happy to help.

4] When Was The Last Time You Sent A Notice Letter To The Beneficiaries Of Your Crummey Trusts? To take advantage of the \$10,000 annual gift exclusion, the trust must contain provisions granting each beneficiary the right to withdraw for a limited time (usually 30 to 60 days) such beneficiary's share of the gift. Each time a gift is made to the trust, the beneficiaries of this trust should receive a notice that a gift has been made and that they have a right to withdraw their share of the gift. This notice letter shows the IRS that you have complied with all of the administrative requirements to ensure that your gift will qualify for the annual exclusion. If Crummey Notices are not yet a part of your estate planning administrative process, call us so we can correct the problem.

5] Do You Have A Buy/Sell Agreement, And Is It Current? Many business owners enter into buy/sell agreements to enhance the continuation of the business, and to protect the business owner's family. An out of date agreement can lead to disaster. Such an agreement might mean that the buy-out price is too low. Even if the price is right, but the buy/sell is not properly funded, your family will suffer as well. So, make sure that your buy/sell agreement is up to date and the valuation and funding provisions are in order. If you have any concerns or questions, please feel free to call upon us.

We recommend to all of our clients that they consider an estate planning check-up every two to three years, or even more frequently if family or financial circumstances dictate. The review is like an x-ray; it is quick and painless. Treat your estate plan like you treat your health. Come and see us for a check-up.

Tom Korman is a partner in our Tax and Estate Planning and Corporate Departments. He may be reached at 312-899-1608 or at tkorman@gould-ratner.com

INCOME TAXATION OF NON-QUALIFIED STOCK OPTIONS

Closely-held business owners often use non-qualified stock options as part of a compensation package for key personnel. There are at least three motivations for entering into this type of compensation arrangement: (1) the employer hopes to ensure the employee's continued service for a fixed number of years; (2) the employee wishes to obtain an equity stake in the business; and (3) both parties desire a tax efficient relationship.

To achieve all of these results, for example, the employer may grant staggered options which are exercisable over a period of years. Upon exercise, the underlying stock may be subject to forfeiture restrictions (vesting) which lapse after the employee completes a specified period of service. Combined with a favorable tax election, this approach seeks to achieve the goals of each party to the transaction at a minimum tax cost.

The following example illustrates this approach:

On July 1, 2000, Closely-Held Corp. grants to Susan, an executive of Closely-Held, non-statutory options to purchase 1000 shares of stock on July 1, 2001 (Block 1), 1000 shares on July 1, 2002 (Block 2), 1000 shares on July 1, 2003 (Block 3), and 1000 shares on July 1, 2004 (Block 4). The options are exercisable for 10 years at an exercise price of \$10 per share. On July 1, 2004, when the fair market value of the Closely Held stock is \$15 per share, Susan exercises all options in full. The stock transferred under the option is nontransferable and vest on the fifth anniversary of the date of exercise. When the restrictions lapse on July 1, 2009, the fair market value is \$50 per share. *[continued on page 4]*

GOULD & RATNER WELCOMES



Christopher J. Horvay joined Gould & Ratner as a Partner, effective November 4, 1999. Prior to joining Gould & Ratner, Chris was the co-chair of the Debtor/Creditor Department of a prominent Chicago law firm. He has represented both debtors and creditors in a number of significant business bankruptcy cases. He recently served (1997-98) as President of the Chicago/Midwest Chapter of The Turnaround Management Association and was elected a National Director of TMA effective October 1, 1999.

Chris earned his JD from Northwestern University School of Law (1976) and his bachelor's degree, magna cum laude, from Syracuse University (1973), where he was elected to Phi Beta Kappa.

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